

Internal Revenue Service

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Department of the Treasury

Washington, DC 20224

Third Party Communication: None

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Person To Contact:

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Refer Reply To:

CC:ITA:B05

PLR-126481-07

Date:

January 28, 2008

Legend:

Department of =
 Taxation

Partnership =
Property #1 =

Taxpayer =

Property #2 =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

Date 6 =

Date 7 =

Date 8 =

Date 9 =

Date 10 =

Date 11 =

Date 12 =

Date 13 =

Date 14 =

Date 15 =

\$m	=
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Dear :

This letter is in response to your request for rulings concerning the tax consequences of discharge of indebtedness in the circumstances described in your request and subsequent correspondence to this office. You requested relief to make a late election under section 108(d)(9) of the Internal Revenue Code to have section 108(c) apply. You also requested a determination concerning the application of section 108.

In the circumstances described, a substantive ruling concerning the extent to which discharge of indebtedness might have qualified for exclusion from gross income under sections 108(a)(1)(B) or (D) would have involved prior years for which tax returns have been filed. Absent a waiver from the business unit of the Internal Revenue Service with jurisdiction over those tax returns, we are precluded from issuing a ruling on issues which involve taxable years for which returns have been filed. We did not advise you to attempt to secure a waiver as the information provided would not have afforded a sufficient basis for a substantive ruling concerning the application of section 108 even if a waiver had been obtained. This letter notes inconsistencies in the information provided and describes additional information that would be necessary to make a determination concerning the application of section 108 in the circumstances described. We attempted to develop the facts through a number of requests for information but did not receive the necessary information. The information contained in

this letter is provided in an effort to assist you and your accountant in determining whether or to what extent various provisions of section 108 may apply. We considered your request for relief to make a late election for application of section 108(c) and, in an attempt to provide assistance, have provided a ruling subject to specific conditions. The conditions are the result of insufficient or conflicting information included in the submission.

FACTS:

The request for ruling indicates that Property #1 was the subject of a foreclosure sale. Based on the information provided, it appears that there may have been a short sale rather than a foreclosure. A Date 11 letter indicates that the purchaser entered into a contract to purchase the property, subject to existing mortgage, liens, and taxes, for \$x. The \$x and \$y, provided by the Taxpayer, was applied to pay the Taxpayer's closing costs.

On Date 5, the purchaser executed a Mortgage Note for \$u payable to the holder of the Taxpayer's mortgage on Property #1. The amount of the Mortgage Note was substantially less than the balance of the Taxpayer's mortgage at the time. It appears that the holder of the mortgage agreed to forgive the difference between the amount of the Taxpayer's outstanding mortgage balance and the principal amount of the Mortgage Note executed by the purchaser in order to facilitate a sale of Property #1.

It is not possible to determine the amount of the indebtedness that was cancelled because the information provided with respect to the outstanding mortgage balance on Date 5 is inconsistent. A portion of an amortization schedule, which is represented to be the amortization schedule for Property #1, indicates that the principal balance of the mortgage would have been approximately \$r on Date 5 when the property was sold. However, a Date 3 letter from an attorney representing the creditor who held the mortgage on Property #1 indicates that the principal balance on Date 2, which was approximately 3 years prior to Date 5, was \$v. If the mortgage balance on the earlier date was less than the balance on the later date it may indicate: (i) the terms of the debt were modified to provide for partial payment of interest with the balance of the interest added to the outstanding balance of the debt; (ii) the creditor's lending of additional amounts to the Taxpayer; or (iii) that delinquent payments had been added to the principal of the loan. If the Taxpayer were granted relief to make a late election for application of section 108(c), it would be necessary to consider the use of all of the proceeds of the indebtedness in order to determine whether, and to what extent, the indebtedness would be properly characterized as qualified real property business indebtedness. A Date 14 letter provided by the Taxpayer's accountant includes a statement indicating that they could not determine the balance of the Taxpayer's mortgage on Date 5. The letter also indicates that the Taxpayer stated that the balance of the mortgage on Property #1 was \$w on Date 5 and that the Taxpayer attributed the difference between \$w and the amount indicated on the amortization schedule to

payments and certain adjustments. The information provided contains no documentation of such payments and adjustments.

The Date 11 letter from the attorney who represented the Taxpayer in the sale of Property #1 indicates that Property #1 was subject to tax liens of \$s on the date of sale. However, the closing statement indicates that purchaser made a payment of \$t to the Department of Taxation; no explanation was provided for the significant difference in the two amounts.

At the time that Property #1 was sold and a portion of the outstanding mortgage was forgiven, the Taxpayer also owned Property #2. Property #2 was used in the Taxpayer's business. A Date 14 letter from the Taxpayer's accountant indicates that the Taxpayer purchased Property #2 for \$oo on Date 15. As of the time of the sale (foreclosure) on Property #1, the Taxpayer's basis in Property #2 was approximately \$qq. As of the beginning of the taxable year which ended on Date 6, the Taxpayer had deducted depreciation of \$pp on Property #2. The information provided does not indicate whether Property #2 was subject to any debt. The Taxpayer orally indicated that Property #2 was subject to debt but no information was provided in support of that statement. Based on the portion of the amortization schedule provided for Property #1, approximately two-thirds of the interest expense claimed by the Taxpayer's business for the year in which the sale (foreclosure) of Property #1 occurred would have been attributable to Property #1 if all the required interest payments indicated on the amortization schedule had been paid. The balance of the interest may have been attributable to debt on Property #2. However, the information provided does not provide a basis for such a determination.

The Taxpayer timely filed, under extension, a return for the taxable year which ended on Date 6. The return included no cancellation of indebtedness income in gross income. On Date 8, the Internal Revenue Service assessed additional tax of \$z based on cancellation of indebtedness income.

On Date 9, the Taxpayer filed amended returns. An amended return included a statement to the effect that the Taxpayer elected to file a Form 982 and reduce the tax attributes of real property due to foreclosure of property while the Taxpayer was insolvent. The line item for discharge of qualified real property business indebtedness was checked on the Form 982. The responses to line items on Form 982 indicated that the amount of discharged indebtedness excluded from gross income was \$rr. No information was provided indicating how that amount was determined. Although the statement on the Amended Return indicates the Taxpayer was insolvent at the time Property #1 was foreclosed, no information was provided on the Amended Return or submitted in connection with the request for ruling to support the statement that the Taxpayer was insolvent immediately before the foreclosure or to indicate the amount, if any, by which the Taxpayer was insolvent.

The Taxpayer contacted the Internal Revenue Service to inquire about the status of the Amended Returns. The Taxpayer mailed the Amended Returns to the office of the Internal Revenue Service. Personnel of the office advised the Taxpayer that they had no record of the Amended Returns and that they should have been mailed to Service Center. The Taxpayer represented that he has certified receipts evidencing the mailing of the Amended Returns.

Based on the experience with the office of the Internal Revenue Service, the Taxpayer contacted the office of the Taxpayer Advocate. A letter from the Taxpayer Advocate's office, which indicates that the Taxpayer contacted that office on Date 11, advised the Taxpayer to request a private letter ruling granting an extension of time to make an election on Form 982 to reduce tax attributes due to discharge of indebtedness. Although the letter did not mention qualified real property business indebtedness, it was apparently intended to refer to such indebtedness. The Taxpayer's request for ruling is dated as of Date 12. The request for ruling did not include the proper user fee or the required penalties of perjury statement. As a result of the necessity to correct those deficiencies, the request for ruling was not assigned until Date 13. Additional information was requested on several occasions in an attempt to develop the relevant factual information necessary for determinations on the requested rulings.

AUTHORITY:

Section 108(a)(1) provides, in part, that gross income does not include any amount which (but for section 108(a)) would be includible in gross income by reason of the discharge (in whole or in part) of indebtedness of the taxpayer if (A) the discharge occurs in a title 11 bankruptcy case, (B) the discharge occurs when the taxpayer is insolvent, (C) the indebtedness discharged is qualified farm indebtedness; or (D) in the case of a taxpayer other than a C corporation, the indebtedness discharged is qualified real property business indebtedness.

Section 108(a)(3) provides that in the case of a discharge to which section 108(a)(1)(B)(discharge when the taxpayer is insolvent) applies, the amount excluded from gross income under section 108(a)(1)(B) shall not exceed the amount by which the taxpayer is insolvent.

Section 108(a)(2)(B) provides that the insolvency exclusion takes precedence over the qualified farm exclusion and the qualified real property business exclusion. The exclusions for discharge of qualified farm indebtedness and qualified real property business indebtedness shall not apply to a discharge to the extent the taxpayer is insolvent.

Section 108(c)(3) provides, in part, that the term "qualified real property business indebtedness" means indebtedness which was incurred or assumed by the taxpayer in

connection with real property used in a trade or business and is secured by such real property and with respect to which such taxpayer makes an election to have this paragraph apply.

Section 108(d)(9) provides that an election under section 108(c)(3) shall be made on the taxpayer's return for the taxable year in which the discharge occurs or at such other time as may be permitted in regulations prescribed by the Secretary.

Section 1.108-5(b) of the Income Tax Regulations provides that an election to exclude the discharge of qualified real property business indebtedness from gross income shall be made on the timely-filed (including extensions) Federal income tax return for the taxable year in which the taxpayer has discharge of indebtedness income that is excludible from gross income under section 108(a). The election is to be made on a completed Form 982, in accordance with the Form 982 and the instructions thereto.

Section 108(c)(1)(A) provides that the amount excluded from gross income pursuant to section 108(a)(1)(D) shall be applied to reduce the basis of the taxpayer's depreciable real property.

Section 108(c)(2)(A) provides that the amount excluded from gross income as discharge of qualified real property business indebtedness under section 108(a)(1)(D) shall not exceed the excess (if any) of (i) the outstanding principal amount of such indebtedness (immediately before the discharge), over (ii) the fair market value of the real property which secures such indebtedness and is used in a trade or business (as of such time) reduced by the amount of any other qualified real property business indebtedness secured by such property (as of such time).

Section 108(c)(2)(B) provides that the amount excluded under section 108(a)(1)(D) (discharge of qualified real property business indebtedness) shall not exceed the aggregate adjusted bases of depreciable real property determined after any reductions under sections 108(b) (reduction of tax attributes) and 108(g) (discharge of qualified farm indebtedness) held by the taxpayer immediately before the discharge (other than depreciable real property acquired in contemplation of such discharge).

Section 301.9100-3 provides that requests, such as the Taxpayer's, for extension of time for regulatory elections that do not meet the requirements of section 301.9100-2 must be made under the rules of section 301.9100-3. Requests for relief will be granted when the taxpayer provides evidence to establish to the satisfaction of the Commissioner that the taxpayer acted reasonably and in good faith, and the grant of relief will not prejudice the interests of the Government.

Section 301.9100-3(b)(1)(iii) provides that a taxpayer is deemed to have acted reasonably and in good faith if the taxpayer failed to make the election because, after

exercising reasonable diligence (taking into account the taxpayer's experience and the complexity of the return or issue), the taxpayer was unaware of the necessity for the election.

Section 301.9100-3(b)(3) provides, in part, that a taxpayer is not deemed to have acted reasonably and in good faith if the taxpayer (i) seeks to alter a return position for which an accuracy related penalty has been or could be imposed under section 6662 at the time the taxpayer requests relief (taking into account any qualified amended return filed within the meaning of section 1.6664-2(c)(3)) and the new position requires or permits a regulatory election for which relief is requested; (ii) was informed in all material respects of the required election and related tax consequences, but chose not to file the election; or (iii) uses hindsight in requesting relief. If specific facts have changed since the due date for making the elections that make the election advantageous to the taxpayer, the IRS will not ordinarily grant relief.

Section 301.9100-3(c) provides the Commissioner will grant a reasonable extension of time to make a regulatory election only when the interests of the Government will not be prejudiced by the granting of relief. Criteria employed in determining when the interests of the Government are prejudiced include; (i) the interests of the Government are prejudiced if granting relief would result in a taxpayer having a lower tax liability in the aggregate for all taxable years affected by the election than the taxpayer would have had if the election had been timely made (taking into account the time value of money); (ii) The interests of the Government are ordinarily prejudiced if the taxable year in which the regulatory election should have been made or any taxable years that would have been affected by the election had it been timely made are closed by the period of limitations on assessment under section 6501(a) before the taxpayer's receipt of a ruling granting relief under this section. The IRS may condition a grant of relief on the taxpayer providing the IRS with a statement from an independent auditor certifying that the interests of the Government are not prejudiced under the standards set forth in section 301.91003(c).

ANALYSIS:

The Taxpayer's amended return includes a statement indicating that the Taxpayer was insolvent at the time of the discharge of a portion of the indebtedness on Property #1. No information was provided with respect to the Taxpayer's financial position or the extent, if any, to which he may have been insolvent immediately before the discharge of indebtedness on Property #1. However, if the Taxpayer was insolvent immediately before the discharge of indebtedness on Property #1, the exclusion for discharge of indebtedness provided by section 108(a)(2)(B) would apply to the extent the Taxpayer was insolvent immediately before the discharge. It will be necessary to determine whether and to what extent, if any, the Taxpayer was insolvent immediately

before the discharge in order to determine how much, if any, of the discharged indebtedness on Property #1 would be excluded from gross income pursuant to section 108(a)(2)(B).

If the Taxpayer was solvent before the discharge of indebtedness on Property #1 or the amount of the indebtedness discharged exceeded the amount by which the taxpayer was insolvent immediately before the discharge, it will be necessary to determine whether the discharged indebtedness was qualified real property business indebtedness. In order to make that determination, it will be necessary to know the balance of the indebtedness on Date 5 and the use of the debt proceeds. The portion of the indebtedness incurred or assumed before January 1, 1993, or incurred or assumed in connection with real property used in the Taxpayer's trade or business and secured by such real property would have been characterized as qualified real property business indebtedness.

If the Taxpayer had elected to have section 108(c) apply and the circumstances satisfied the requirements of section 108(c), discharge of all or a portion of the qualified real property business indebtedness may have been excluded from gross income pursuant to section 108(a)(1)(D). The Taxpayer has requested relief to make a late election to have section 108(c) apply.

On the basis of the information provided, It is not possible to determine what portion, if any, of the discharged indebtedness on Property #1 would be treated as the discharge of qualified real property business indebtedness if the taxpayer were allowed to make a late election to have section 108(c) apply. In order for a portion of the discharged indebtedness to have qualified for exclusion from gross income under section 108(a)(1)(D), it would have been necessary that the Taxpayer either have been solvent at the time of the discharge or that the amount of the indebtedness discharged exceeded the amount by which the Taxpayer was insolvent immediately before the discharge. As previously indicated, the information provided does not provide a basis for determining whether the Taxpayer was insolvent immediately before the discharge; the amount of indebtedness that was discharged; or a determination of the portion of the indebtedness which would have been properly characterized as qualified real property business indebtedness if the Taxpayer had made an election to have section 108(c) apply.

If the period of limitations on assessment under section 6501(a) is closed for the Taxpayer's taxable year that ended on Date 6 or any subsequent taxable year, granting the Taxpayer relief to make a late election under section 108(c) would prejudice the interests of the government if the circumstances otherwise satisfied the provisions of section 108(c) and resulted in the exclusion of discharge of qualified real property business indebtedness. As a result of the exclusion provided by section 108(a)(1)(D) for the discharge of qualified real property business indebtedness, section 108(c)(1)(A) requires that the amount excluded from gross income be applied to reduce the basis of

the taxpayer's depreciable real property. In order to take account of the basis reduction and the resulting reduction in the amount of depreciation claimed for each year subsequent to the Taxpayer's taxable year that ended on Date 6, it would be necessary that the period of limitations on assessment under section 6501(a) for each of those years not be closed. If the period of limitations for any of those years was closed, it would not be possible to amend the return for such year to take account of the reduction in the depreciation deduction resulting from the basis reduction required by section 108(c)(1) as a result of the exclusion of the discharge of qualified real property business indebtedness from gross income. If the period of limitations for any of those periods was closed, granting the Taxpayer's request for relief would prejudice the interests of the government as the Taxpayer's tax liability in the aggregate for all taxable years ending after Date 6 was lower than it would have been if the election had been timely made (taking into account the time value of money).

CONCLUSION:

Provided that: (i) the period of limitations on assessment under section 6501(a) is open for the Taxpayer's taxable year which ended on Date 6 and for each subsequent taxable year; (ii) the indebtedness on Property #1 would be properly characterized as qualified real property business indebtedness; (iii) the Taxpayer either was solvent immediately before the discharge of indebtedness on Property #1 or the amount of indebtedness discharged was in excess of the amount by which the Taxpayer was insolvent; (iv) the amount subject to exclusion under section 108(a)(D) is determined in accordance with the limitations provided in section 108(c)(2); the Taxpayer's request for relief to make a late election for application of section 108(c) is granted.

The ruling contained in this letter is based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. Specifically, no opinion is expressed concerning: (i) whether and to what extent, if any, the Taxpayer was insolvent immediately before the discharge of indebtedness on Property #1; (ii) the characterization of the indebtedness on either Property #1 or Property #2 as qualified real property business indebtedness; (iii) the outstanding balance of the indebtedness on Property #1 or Property #2 at any time; (iv) the amount of discharged indebtedness excluded from the Taxpayer's income under either section 108(a)(1)(B) or (D); and (v) whether the period of limitations for assessment of tax is open for any taxable year of the Taxpayer which could be impacted by the circumstances described in this letter.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

Sincerely,

William A. Jackson
Chief, Branch 5
(Income Tax & Accounting)